CALIFORNIA FRANCHISE TAX BOARD

Legal Ruling No. 378

August 27, 1974

LIMITATION ON DEDUCTION OF INVESTMENT INTEREST EXPENSE

Syllabus:

Gains from capital assets held one year or less are not included in the amount referred to in Section 17203(d)(1)(C). The word "recognized" in Section 17203(d)(1)(C) refers to capital gain and loss before the percentages set forth in Section 18162.5 have been applied. Capital gains are offset against investment interest expense on a prorated basis. Capital gains converted to ordinary income by operation of Section 17203(d)(5) are treated as ordinary income for all purposes.

Facts:

Revenue and Taxation Code Section 17203 provides in material part that:

> . . .
>
> (d)(1) The amount of investment interest (as defined in subparagraph (D) of paragraph (3)) otherwise allowable as a deduction . . . shall be limited, in the following order, to --
>
> (A) Twenty-five thousand dollars ($25,000) (twelve thousand five hundred ($12,500), in the case of a separate return by a married individual), plus
>
> (B) The amount of the net investment income (as defined in subparagraph (A) of paragraph (3) . . ., plus
>
> (C) An amount equal to the amount by which the total amount of capital gains recognized exceeds the total amount of capital losses recognized for the taxable year, plus
>
> (D) One-half of the amount by which investment interest exceeds the sum of the amounts described in subparagraphs (A), (B), and (C).
>
> . . .
>
> (d)(5) The amount equal to the amount of investment interest which is allowable as a deduction by reason of subparagraph (C) of paragraph (1) of this subdivision shall be treated as gain from the sale or other disposition of property which is neither a capital asset nor property described in Sections 18181 and 18182.

Questions:

1. Are the gains from capital assets held one year or less included in the amounts referred to in both Section 17203(d)(1)(B) and Section 17203(d)(1)(C)?

2. Does the word "recognized" in Section 17203(d)(1C) refer to capital gain and loss before or after the percentages set forth in Section 18162.5 have been applied?

3. When the capital gains referred to in Section 17203(d)(1)(C) are used to reduce interest expense disallowed, in what order are the gains from assets held more than one year but less than five, and over five years, applied?

4. If capital gains on assets held more than one year are used to increase the amount of deductible investment interest expense allowed, and are converted to ordinary income pursuant to Section 17203(d)(5), are they: (a) to be used in computing tax preference income? (b) to be excluded from taxable income in computing the 1973 special tax credit under Section 17069.5?

Decisions:

1. No, they are included only in the amount referred to in Section 17203(d)(1)(B).

2. Before the percentages are applied.

3. Capital gains from assets held for the two holding periods in question are to be applied against investment interest expense in the same ratio that the amount of gain from capital assets held for the particular holding period bears to the total capital gains attributable to those two holding periods.

4. (a) No. (b) No.

Discussion:

Question 1

Gains from capital assets held one year or less are included by definition in the amount referred to in Section 17203(d)(1)(B). See Section 17203(d)(3)(B)(ii).

Read alone it might seem that the "total amount of capital gain" referred to in Section 17203(d)(1)(C) would include all capital gains including those attributable to assets held for a period of one year or less. But phrases in a statute are not to be read in isolation. In construing a statute it must be considered as a whole and words or clauses may be enlarged or restricted to effectuate the legislative intention or to harmonize them with other expressed provisions. (45 Cal.Jur.2d § 118.)

In this regard it must be noted that Section 17203(d)(5) provides in effect that to the extent the "total amount of capital gain" referred to in Section 17203(d)(1)(C) is used to increase the amount of investment interest expense deductible it must be converted into and be taken into account as ordinary income. Read in light of Section 17203(d)(5), therefore, it seems clear that in referring to the "total amount of capital gain" in Section 17203(d)(1)(C), the Legislature meant the total amount of capital gain which can be converted into and be taken into account as ordinary income.

Gains from capital assets held for a period of one year or less cannot be converted into ordinary income. They are already taken into account at one-hundred percent like ordinary income. Consequently, capital gains attributable to assets held for a period of one year or less are not included in the amount referred to in Section 17203(d)(1)(C).

This construction is fully supported by the legislative history of Section 17203(d) which was adopted to conform to Internal Revenue Code section 163(d). Section 163(d)(1)(C), which is the federal counterpart of Section 17203(d)(1)(C), does not include capital gains which are taken into account like ordinary income at one-hundred percent.

Question 2

It is clear that the Legislature used the word "recognized" in Section 17203(d)(1)(C) to refer to the entire capital gain before the application of the percentages set out in Section 18162.5. After applying the percentages set out in Section 18162.5, the capital gain referred to in subparagraph (C) is, in effect, converted into ordinary income and Section 17203(d)(5) which purports to convert certain said capital gain to ordinary income would be rendered nugatory under any other interpretation. It must be presumed that every word, phrase, and provision in a statute was intended to have some meaning and to perform some useful office, and a construction implying that words were used in vain, or that they are surplusage, will be avoided. (45 Cal.Jur.2d § 117.) To give effect to the provisions of Section 17203(d)(5), the word "recognized" in Section 17203(d)(1)(C) must be construed therefore to refer to the total gain (or loss) from capital assets before application of the percentages set forth in Section 18162.5.

Question 3

Section 17203(d)(1) specifies the order in which various items enumerated in Section 17203(d)(1)(A) through Section 17203(d)(1)(D) are to be offset against investment interest expense. In doing so, however, Section 17203(d)(1) treats the amount of capital gain referred to in Section 17203(d)(1)(C) as a single undifferentiated whole whereas the capital gain referred to therein may actually be comprised of two separate categories which are taken into account either at 65% or 50% depending upon the length of time that the capital asset was held. Therefore, in order to determine which capital gains are converted to ordinary income under Section 17203(d)(5) when the capital gain referred to in Section 17203(d)(1)(C) does consist of both categories, and when the amount of investment interest expense to be offset is less than the sum total of both categories, the question arises as to which category of capital gain is to be offset against investment interest expense first.

By not providing the order in which the two categories of capital gain are to be offset against investment interest expense, Section 17203(d)(1) provides in effect that both categories are to be offset against investment interest expense simultaneously. Hence, the dictates of Section 17203(d)(1) can be most nearly approached by prorating. Specifically, the investment interest expense remaining after the specific exemption and net investment interest have been offset against it will be offset by capital gain for the particular holding period in the same ratio that the amount of gain from capital assets held for the particular holding period bears to the total capital gains attributable to both of the particular holding periods.

The formula can be expressed as follows:

Amount of capital gain for the particular holding period / Total capital gain (amount referred to in Section 17203(d)(1)(C) X Investment interest expense remaining after the specific exemption and net investment income have been offset against it = The amount of capital gain for the particular holding period offset against investment interest

For example:

1. Assume taxpayer has the following formula factors:

a. Investment Interest Expense		$50,000
b. Specific Exemption	$25,000	
c. Net Investment Income	5,000	-30,000
d. Investment Interest Expense		$20,000
e. Capital Gain Attributable to Assets Held for More Than One Year But Less Than Five	$40,000	
f. Capital Gain Attributable to Assets Held for More Than Five Years	10,000	
g. Capital Losses /1	-0-	
h. Amount Referred to in Section 17203(d)(1)(C)	$50,000	

NOTE: If the amount on line d. is equal to or greater than the amount on line h., the capital gain will not be prorated. In such cases all of the capital gain in question will be offset against investment interest expense and the order of offset is immaterial.

2. Taxpayer's capital gain would be prorated as follows:

a. Gain attributable to capital assets held more than one year but less than five.

$40,000 / $50,000 X $20,000 = $16,000

Hence, $16,000 of this category of capital gain is offset against investment interest expense and loses its character as capital gain. The remaining $24,000 of this category of capital gain is still treated as capital gain.

b. Gain attributable to capital assets held for more than five years.

$10,000 / $50,000 X $20,000 = $4,000

Hence, $4,000 of this category of capital gain loses its character as capital gain. The remaining $6,000 is still treated as capital gain.

Question 4

Section 17203(d)(5) provides that capital gain which is used to increase the amount of deductible investment interest is to be treated as "gain from the sale or other disposition of property which is neither a capital asset nor property described in Sections 18181 and 18182." Section 17203(d)(5) contains no qualifications of this rule. Consequently, such converted capital gain is to be considered ordinary income for all purpose of computing tax preference income or for the purpose of computing taxable income in determining the amount of the special 1973 tax credit.

Footnote /1 Where there are capital losses, they are deducted in the following manner. First, losses in the 65% and 50% holding period categories are netted against gains in the respective categories. Secondly, the net loss, if any, from either of these two holding period categories is netted against the gain from the other holding period category. Thirdly, any net loss attributable to capital assets held for a period of one year or less is deducted from the gain attributable to the other holding period categories in the same ratio that the net gain from the particular holding period category bears to the total net gains from the other two holding period categories. The resulting figure is the "amount of capital gain for the particular holding period" referred to in the proration formula set forth above.